

Initial Statement of Reasons

Proposed Adoption of California Code of Regulations, Title 18, Section 2558.1, *Wine*

SPECIFIC PURPOSE AND NECESSITY

Current Law

Article XX, section 22 of the California Constitution authorizes and requires the Board to assess and collect all excise taxes that are or may be imposed on the manufacture, importation, and sale of alcoholic beverages. RTC section 32451 expressly authorizes the Board to administer the Alcoholic Beverage Tax Law and adopt regulations relating to its administration and enforcement. And RTC section 32152 authorizes the Board to adopt regulations to coordinate California's and the federal government's systems for taxing beer and wine, so far as permitted by the express provisions of the Alcoholic Beverage Tax Law.

The Alcoholic Beverage Tax Law imposes different excise taxes on distilled spirits, beer, and wine, and the rates of the excise tax on distilled spirits are substantially higher than the rates of the excise tax imposed on beer and wine. (See RTC §§ 32151 (beer and wine) and 32201 (distilled spirits).) Still wines are taxed at a rate of one or two cents per gallon, beer is taxed at a rate of \$1.24 per 31 gallon barrel (or approximately 4.5 cents per gallon), and liquid distilled spirits are taxed at a rate of \$2 or \$4 per gallon.

RTC section 32002 provides that the definitions contained in chapter 1 (sections 23001-23047) of division 9 of the BPC apply to the terms used in the Alcoholic Beverage Tax Law. This includes the definitions in BPC sections 23005, 23006, and 23007, which define "distilled spirits," "beer," and "wine," respectively, and provide that:

23005. "Distilled spirits" means an alcoholic beverage obtained by the distillation of fermented agricultural products, and includes alcohol for beverage use, spirits of wine, whiskey, rum, brandy, and gin, including all dilutions and mixtures thereof.

23006. "Beer" means any alcoholic beverage obtained by the fermentation of any infusion or decoction of barley, malt, hops, or any other similar product, or any combination thereof in water, and includes ale, porter, brown, stout, lager beer, small beer, and strong beer but does not include sake, known as Japanese rice wine.

23007. "Wine" means the product obtained from normal alcoholic fermentation of the juice of sound ripe grapes or other agricultural products containing natural or added sugar or any such alcoholic beverage to which is added grape brandy, fruit brandy, or spirits of wine, which is

distilled from the particular agricultural product or products of which the wine is made and other rectified wine products and by whatever name and which does not contain more than 15 percent added flavoring, coloring, and blending material and which contains not more than 24 percent of alcohol by volume, and includes vermouth and sake, known as Japanese rice wine.

Therefore, the Board must determine whether an alcoholic beverage is a distilled spirit, beer, or wine in order to determine which excise tax and which excise tax rate applies to that beverage under the Alcoholic Beverage Tax Law.

In late 2006, the Board received information that there were alcoholic beverages being sold as beer in California because they were made from the fermentation of malt or similar products, but which might also contain alcohol derived from the distillation of fermented agricultural products. This was because the federal government adopted alcoholic beverage regulations allowing “flavored malt beverages” to be labeled, advertised, and taxed like beer for federal purposes, and also allowing flavored malt beverages to contain specified amounts of alcohol from the distillation of fermented agricultural products. (See 27 C.F.R. §§ 7.1-7.81, 25.15.)

The Board determined that the definition for “beer” set forth in BPC section 23006 did not allow beer to contain alcohol from the distillation of fermented agricultural products. The Board also determined that beverages containing alcohol from the distillation of fermented agricultural products had to be classified as either distilled spirits or wine because the definitions for distilled spirits and wine in BPC sections 23005 and 23007 do allow those beverages to contain alcohol from the distillation of fermented agricultural products.

Based upon these determinations, the Board concluded that flavored malt beverages that are derived from the fermentation of malt or similar products and only contain a de minimis amount of alcohol from flavorings that are derived from the distillation of fermented agricultural products could consistently be classified as beer for federal and California purposes. However, the Board also concluded that flavored malt beverages containing more than a de minimis amount of alcohol from the distillation of fermented agricultural products had to be classified as a distilled spirits for California tax purposes because the beverages were “obtained from the distillation of fermented agricultural products” as provided in BPC section 23005 and were clearly not wine. Therefore, the Board adopted Regulations 2558 through 2559.5 to prospectively clarify that alcoholic beverages are classified as distilled spirits under BPC section 23005 if they contain “0.5 percent or more alcohol by volume derived from flavors or other ingredients containing alcohol obtained from the distillation of fermented agricultural products” (Regulation 2558), regardless of the alcoholic beverages’ classification for federal purposes, and create a rebuttable presumption that all alcoholic beverages are distilled spirits for California tax purposes, effective October 1, 2008. (Regulations 2559-2559.5.) However, the distilled spirits regulations (Regulations 2558-2559.5) did not apply to

wine, as defined in BPC section 23007, which may contain alcohol that is distilled from the particular agricultural product or products of which the wine is made.

Proposed Regulation

Part 24.10 of title 27 of the Code of Federal Regulations provides the general definition of wine for federal purposes and provides that: “When used without qualification, the term [wine] includes every kind (class and type) of product produced on bonded wine premises from grapes, other fruit (including berries), or other suitable agricultural products and containing not more than 24 percent alcohol by volume. The term includes all imitation, other than standard, or artificial wine and compounds sold as wine. A wine product containing less than one-half of one percent alcohol by volume is not taxable as wine when removed from the bonded wine premises.”

While Board staff was working with the manufacturers and brewers of flavored malt beverages to implement the distilled spirits regulations, staff was also in communication with wine growers and importers regarding wine-based products that are classified as wine for federal purposes, but may not meet the BPC section 23007 definition for wine. This is because BPC section 23007 expressly allows alcoholic beverages to be classified as wine if they include grape brandy, fruit brandy, or spirits of wine, which is distilled from the particular agricultural product or products of which the wine is made, but does not expressly allow alcoholic beverages to be classified as wine if they include alcohol derived from the distillation of other fermented agricultural products; and BPC section 23007 limits the amount of flavoring, coloring, and blending materials that can be added to wine. However, federal law allows alcoholic beverages to be classified as wine regardless of the source of their alcohol and federal law does not limit the amount of flavoring, coloring, and blending materials that can be added to wine.

As a result, Board staff issued two Special Notices to the wine industry, which both clarified that the distilled spirits regulations apply to all alcoholic beverages that do not meet the BPC section 23007 definition for wine. The first notice was dated December 2008, entitled *Special Notice to Wine Growers and Importers*, and mailed to wine grower and wine importer registrants. The notice advised producers and importers of wine-based alcoholic beverages that might not meet the statutory definition for wine, but which do not contain 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products to consider rebutting the presumption in Regulation 2559 by filing form BOE 505, *Alcoholic Beverage Tax Report for Rebutting Regulation 2559 Presumption*. Summaries of the distilled spirits regulations were included with this notice.

The second notice was dated December 2009, entitled *Alcoholic Beverages Taxed as Wine for Federal Purposes, May Not Meet California’s Definition of Wine and Therefore May be Subject to Tax as Distilled Spirits for California Tax Purposes*, and was mailed to all of the Board’s alcoholic beverage program accounts. The second notice advised that certain types of alcoholic beverages that may qualify as wine for federal classification purposes, namely wine specialties, flavored table wine, wine cocktails, wine coolers or

other wine-based products or blends of wine from different fruits, may not meet California's definition of wine under BPC section 23007 and, therefore, may be considered distilled spirits and be taxed accordingly for California purposes. The notice also advised each manufacturer, grower, or importer to review California's wine definition, and if their product(s) did not meet California's definition of wine, to file form BOE-505, if appropriate, to rebut the distilled spirits presumption.

However, based on field visits to major producers of wine-based alcoholic beverages in 2010, staff became aware that significant differences of opinion and confusion still existed as to the proper classification of nonstandard, wine-based products after the 2008 and 2009 notices were issued. Specifically, disagreement existed in the wine industry as to whether water constituted a blending material subject to BPC section 23007's limitation on blending materials. And confusion existed in the wine industry as to the rules governing, and the tax consequences of, introducing distilled alcohol to wine-based products. Therefore, Board staff prepared an Informal Issue Paper dated November 2, 2010, and submitted it to the Board Members for consideration at the Board's November 16, 2010, meeting.

The Informal Issue Paper summarized the information provided above, requested the Board's authorization for staff to initiate an interested parties process to discuss the two issues affecting the classification of wine more thoroughly, and included the following exhibits:

1. Regulations 2558 through 2559.5;
2. Formal Issue Paper 07-007 dated August 3, 2007, regarding the classification of flavored malt beverages and recommending that the Board begin the formal rulemaking process to adopt Regulations 2558 through 2559.5, which was submitted to the Board Members for consideration at the Board's August 14, 2007, meeting;
3. The minutes from the Board's August 14, 2007, meeting showing that the Board authorized staff to begin the formal rulemaking process to adopt Regulations 2558 through 2559.5;
4. The December 2008 Special Notice (discussed above);
5. The December 2009 Special Notice (discussed above); and
6. An initial draft of Regulation 2558.1, *Wine*, that staff wanted to discuss with interested parties because it raised various issues with regard to the classification of wine-based products.

As relevant here, the initial draft of Regulation 2558.1 included as exhibit 6 to the Informal Issue Paper indicated that wine-based alcoholic beverages that only contain a de minimis amount of alcohol from flavorings, colorings, or blending materials that are derived from the distillation of fermented agricultural products other than the particular agricultural product or products of which the wine is made could consistently be classified as wine for federal and California purposes. However, wine-based alcoholic beverages containing more than a de minimis amount of alcohol (0.5% or more by volume) from the distillation of fermented agricultural products other than the particular

agricultural product or products of which the wine is made had to be classified as distilled spirits for California tax purposes because the beverages were “obtained from the distillation of fermented agricultural products” as provided in BPC section 23005 and were clearly not wine within the meaning of BPC section 23007.

On November 16, 2010, the Board authorized staff to conduct an interested parties meeting to discuss the draft of Regulation 2558.1 included as exhibit 6 to the Informal Issue Paper. During the interested parties process, including the interested parties meeting on December 17, 2010, Board staff learned that there was considerable disagreement in the wine industry regarding whether water should be treated as a blending material. Staff determined that the addition of any amount of water to a wine-based alcoholic beverage would not make that beverage into a distilled spirit within the meaning of BPC section 23005, assuming that the wine-based alcoholic beverage did not contain alcohol from the distillation of fermented agricultural products other than the particular agricultural product or products of which the wine is made. And staff found that there appeared to be a general acceptance among the interested parties that, notwithstanding any objections they have, in general, to the existence of the distilled spirits regulations themselves, a wine-based alcoholic beverage containing distilled alcohol from a foreign source of 0.5 percent or more by volume would not be considered a wine under BPC section 23007 and would be classified as a distilled spirit under BPC section 23005 and Regulations 2558 through 2559.5 for tax purposes.

Following the interested parties meeting, Board staff prepared Formal Issue Paper 11-001 dated February 4, 2011, and submitted it to the Board Members for consideration at the Board’s February 23, 2011, meeting. The Formal Issue Paper recommended that the Board authorize staff to begin the formal rulemaking process to adopt alternative 1 for Regulation 2558.1, which provided as follows:

- (a) Effective January 1, 2012, wine as defined by Business and Professions Code section 23007 does not include any alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made.
- (b) Except as provided in subdivision (a), wine-based products authorized for sale as wine by the Department of Alcoholic Beverage Control are deemed to be wine as defined by Business and Professions Code section 23007 for purposes of the Alcoholic Beverage Tax Law.

The proposed language of alternative 1 focused solely on the addition of alcohol derived from the distillation of agricultural products to wine-based alcoholic beverages and expressly clarified that wine does not include any wine-based alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made so that these types of wine-based alcoholic beverages will clearly be classified as distilled spirits under Regulation 2558. The proposed language included a January 1, 2012, effective date to permit wine growers and importers

who had been relying on federal law and/or the Department of Alcoholic Beverage Control's (ABC's) classification of their wine-based alcoholic beverages for California tax purposes time, without being penalized due to any prior confusion in the industry, to determine whether their wine-based alcoholic beverages are wine or distilled spirits under the Board's regulations, reformulate any of their wine-based alcoholic beverages so that they can continue to qualify as wine for California tax purposes, if necessary and desired, and begin to report and pay the applicable wine or distilled spirits excise tax on their wine-based alcoholic beverages.

The Formal Issue Paper also included two other alternative proposals for Regulation 2558.1, which were both based upon the draft of Regulations 2558.1 included as exhibit 6 to the Informal Issue Paper. Alternative 2, which was supported by former Acting Board Member Barbara Alby, contained proposed language that would clarify that water and juice from the same agricultural products from which the wine is made are not flavorings, colorings, or blending materials. Alternative 3, which was supported by E & J Gallo, contained proposed language that would define the term "wine base" and clarify that water is a blending material when added to a wine base. However, Board staff did not recommend that the Board choose these alternatives over Board staff's alternative 1 because of the dispute within the industry as to whether water should be treated as a flavoring, coloring, or blending material and because the addition of water was not crucial to the classification of an alcoholic beverage as either a wine or distilled spirit for California tax purposes. And alternatives 2 and 3 were withdrawn from the Board's consideration by their sponsors prior to the February 23, 2011, meeting.

After hearing public comments, including E & J Gallo's comments supporting staff's alternative 1, during its February 23, 2011, meeting, the Board determined that it was necessary to adopt Regulation 2558.1 to clarify the rules governing, and the tax consequences of, introducing distilled alcohol to wine-based products, and the Board authorized staff to begin the formal rulemaking process for the Board to adopt staff's alternative 1 for Regulation 2558.1 for the specific purposes of:

1. Clarifying that for purposes of the Alcoholic Beverage Tax Law wine, as defined by BPC section 23007, does not include any alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made; and
2. Establishing January 1, 2012, as the prospective date for compliance with the clarified definition of wine.

Finally, it should be noted that ABC treats all wine-based alcoholic beverages as wine for California labeling and licensing purposes if the beverages are classified as wine for federal purposes, regardless of whether the beverages contain 0.5 percent or more by volume of alcohol obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made or whether the blending material exceeds 15 percent by volume. Also, ABC treats all flavored malt beverages classified as beer for federal purposes as beer for California

labeling and licensing purposes, regardless of whether the beverages contain alcohol derived from the distillation of fermented agricultural products and would be classified as distilled spirits under BPC section 23005 and the distilled spirits regulations. However, the Board has its own independent constitutional and statutory authority to adopt regulations implementing, interpreting, and making specific the provisions of BPC sections 23005, 23006, and 23007 as they apply to the classification of alcoholic beverages under the Alcoholic Beverage Tax Law, the Office of Administrative Law has recognized that authority by approving the distilled spirits regulations, and ABC has not identified any binding or persuasive authority requiring the Board to acquiesce to the federal government's classification of alcoholic beverages where the federal classification conflicts with the express language of the BPC.

DOCUMENTS RELIED UPON

The Board relied upon the Informal Issue Paper dated November 2, 2010 (discussed above), including the exhibits thereto, and Formal Issue Paper 11-001 dated February 4, 2011 (discussed above), including the exhibits thereto, in deciding to propose the adoption of Regulation 2558.1. The Board also relied upon comments made by Board staff and interested parties during its discussions of proposed Regulation 2558.1 at its November 16, 2010, and February 23, 2011, meetings.

ALTERNATIVES CONSIDERED

The Board did consider alternative 2 for Regulation 2558.1 (discussed above), which would have clarified that water is not a flavoring, coloring, or blending material for purposes of BPC section 23007. And the Board also considered alternative 3 for Regulation 2558.1 (discussed above), which would have defined the term "wine base" and clarified that water is a blending material when added to a wine base. However, the Board did not agree with either alternative because there is still general disagreement in the wine industry as to whether water should be classified as a blending material and the Board has determined that it is not necessary to determine whether water is or is not a blending material in order to determine whether a wine-based alcoholic beverage is or is not a distilled spirit for tax purposes.

NO ADVERSE ECONOMIC IMPACT ON BUSINESS

The Board has determined that the adoption of proposed Regulation 2558.1 merely clarifies when the addition of alcohol derived from the distillation of fermented agricultural products to wine-based alcoholic beverages will cause the beverages to be classified a distilled spirits, instead of wine, under the express definitions of "distilled spirits" and "wine" found in BPC sections 23005 and 23007, respectively. Furthermore, the proposed regulation includes an effective date to give wine growers and importers an opportunity to reformulate their nonconforming, wine-based alcoholic beverages so that they can continue to be classified as wine for California tax purposes after the regulation becomes effective. Therefore, the Board has made an initial determination that the

adoption of proposed Regulation 2558.1 will not have a significant adverse economic impact on business.

The proposed regulation may affect small business.